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Commerce and Banking: The German Case

The appropriate relationship between banking and commerce is a central issue in the debate over banking reform. Reluctance to allow their commingling in the U.S. financial system has been marked by concerns over self-dealing and excessive risk-taking that may destabilize the banking system and possible exploitation of the bank safety net.

In this *Letter*, the effects of mixing banking and commerce are discussed in light of the banking experience in West Germany. In West Germany, where "universal banking" is permitted, banks engage directly in investment banking, insurance, and real estate investment activities. They also own (or exercise proxy rights over) large blocks of shares in German industrial enterprises, and serve on the supervisory boards of German corporations. Approximately 80 percent of the 400 largest German corporations have bankers on their management committees, and about 15 percent of corporate equities are estimated to be held by banks. Over half of the shares of the top 100 or so German corporations are voted by banks.

In addition, there is no law prohibiting ownership of banks by commercial enterprises. One finds banks (and other depository institutions) owned by such diverse enterprises as bakeries, automobile manufacturers, retailers, and insurance companies. The German banking experience thus seems a natural laboratory for examining the effects of commingling banking and commerce.

Origins of German universal banking
German universal banks first appeared during the 1850s to serve rapid industrial development. The so-called Kreditbanken provided not only a source of credit and payment services to industry, but also investment banking services (such as securities underwriting) and those of a development bank or venture capital market. In the latter role, they assisted in the start-up of industrial enterprises by providing credit. The credit was of medium-term, and would be repaid with the proceeds of bond and stock issuance once the firm became established.

Interlocks between banks and their industrial customers arose out of these lending practices. Because the activities for which banks were lending were risky and untried, the banks needed mechanisms to obtain good information and, if necessary, control over the activities of their industrial customers. Thus, the lending agreements often required that banks be given a say in the management of the firms, control over how much borrowing the firm did elsewhere, and rights to acquire equity interests in the firm. As the firm's underwriter, the universal bank also had some influence over the timing of bond and stock issuance, which could be used to help ensure that the conditions of the bank loan liquidation were met.

The universal bank form was highly successful and quickly replaced the existing form of banking organization — the "private bank", which was not stockholder-owned and did not offer the same broad range of services. Banks with broad powers have remained dominant among German financial institutions. In their various forms, the universal banks today account for about 75 percent of German banking assets.

Improve efficiency?
A number of theoretical arguments can be made in favor of universal banking-type links to commercial firms. One is that the participation of the bank in managing a firm that is borrowing funds can facilitate efficient credit flow. Specifically, some economists have argued that bank lending is superior to open market financing for certain types of projects because banks can economically monitor those projects on an ongoing basis whereas credit markets cannot. It follows from this argument that if banks can improve their monitoring — by gaining entry to the internal decisionmaking processes of a firm, for example, they can also identify and finance an otherwise unexploited set of projects.

Another line of reasoning suggests that a bank, by simultaneously lending to and owning the equity of a corporation, can help control inefficiency arising from so-called "agency" problems in corporations. Agency problems arise because management, which acts in the role of "agent" for the debt- and equityholders of the firm, may pursue goals that are inefficient and self-serving rather than goals that benefit the liabilityholders.

If the various liabilities of the firm were held by separate investors, the only mechanism for control would be for debtholders to force the firm into bankruptcy or for the equityholders to remove incompetent management through proxy fights. These mechanisms are cumbersome; moreover, debt- and equityholders may have conflicting interests in effecting such change. The prevalence of agency problems and the difficulties of exerting control over an "open" corporation are believed by some to have stimulated the corporate takeover movement in the United States.

If, instead, a bank were to own the full range of classes of both the firm's debt and equity, the bank could gain the control necessary to effect re-organization much more economically. The covenants of the loans and other liabilities can be designed to give the bank progressively greater authority to intercede in the management of the firm as dividend and interest payment performance deteriorates. Moreover, because the debtholder is also the equityholder, there are no conflicts between holders of debt and equity securities to impede a needed re-organization. The result would be fewer agency problems, lower costs in "work-outs" of financial problems, and a resultant increase in organizational efficiency.

Anecdotal evidence

Proponents of universal banking claim that the system has indeed improved the efficiency of Germany's economy. Alexander Gerschenkron and others, for example, believe that the empirical record implies that universal banking contributed to the rapid pace of German industrial development. (It is interesting to note in this regard that Japan, which presents another example of rapid economic development, also traditionally permitted affiliation of commerce and banking in the form of Zaibatsu groups.)

Also consistent with the theoretical rationale for universal banking is the fact that bank loans are the major source of industrial credit, particularly for larger corporations in Germany. (About 70 percent of external corporate funding is obtained from banks in Germany, versus only about 25 percent in the U.S.) That is, the purely "open" form of corporation, with direct placement of corporate debt, seems unable to compete with firms financed with the help of universal banks. The fact that universal banks' creditor relationships tend to be with larger corporations also is to be expected because agency problems are likely to be more serious for larger and more complex organizations.

Finally, in Germany, corporate takeovers are rare by U.S. standards, and banks are involved more frequently in major workouts of a firms' problems and in replacement of its management. This, too, is consistent with the notion that universal banking may help resolve corporate control problems.

Interestingly, a type of financing — called "strip financing" — that is used in corporate restructurings in the U.S. in recent years can be seen as a variant of universal bank-type financing. In strip financing, creditors own a bit of each type of the firm's liabilities. This gives them the type of control that universal banks enjoy as both a lender and an equityholder in their client firms.

Other views

The view of universal banks as an efficiency-enhancing form of financial organization is not universally held. Within modern Germany, there is concern about the concentration of economic power that some feel results from the interlocking ownership of banking and commercial firms. They argue, for example, that these interlocks result in limited credit flows to smaller firms. The German Federal Monopolies Commission recently recommended that banks be allowed to own no more than 5 percent of the shares of a nonbank firm rather than the 25 percent limit enforced currently.

Another broad area of concern raised by the practice of universal banking is its effects on the stability of the banking system itself. In particular, can a bank that offers lending, investment banking, and securities trading services, and that has equity interests in nonbank firms (or vice versa) avoid conflicts of interest that may generate losses of confidence and destabilize the banking system?

Economists argue that competition is the bank customers' main protection against a bank trying to benefit itself or others at the customers' expense. A bank that is not careful to avoid conflicts of interest risks losing its customers (and reputation) to other banking firms. There is little evidence that German banking suffers from insufficient competition. At present there are approximately 4800 banks able to provide universal banking services — 250 commercial banks, 600 savings banks, and 4000 cooperative banks. In addition, German banking is no more concentrated than U.S. or other European banking systems, and profits in the domestic German banking markets appear to be low.

There also are some reasons to believe that universal-type banking may actually contribute to the stability of the banking system and the economy. Bernanke and Gertler, for example, have theorized that banks withdraw from the credit intermediation process when they perceive a deterioration in the collateral value of illiquid bank assets. Their tendency to do so then exaggerates the effects of any economic downturn that may have triggered the initial perception. If this theory were true, allowing banks to hold the equity of borrowing firms could reduce the incentive for banks to abandon the firms in adverse times, since abandoning them could impair the value of equity assets held by the banks.

Nakatani at Osaka University finds corroborating evidence in Japanese banking for Bernanke and Gertler's theory. He finds that the earnings of firms with intimate relationships with financial institutions are less variable than those of firms without. Germany's economy, with its many examples of universal banks providing assistance to weakened firms, has been notably stable in the postwar period.

Effects of deposit protection

A second, thornier issue with universal banking is whether it is possible for government to provide some protection against systemic banking collapse without, ultimately, also shouldering what should be commercial risks. For example, if a bank can own corporate equities, and finance them with default-free debt (insured deposits), some risk effectively is transferred to the insuring entity. Similarly, if a commercial firm can own an insured bank, the possibility arises that the commercial firm will exploit the bank to finance risky investments.

Until 1976, Germany did not have explicit deposit insurance. Instead, it sought to re-assure depositors through a stated general policy of protecting the banking system against failure. The policy still exists and is implemented through examination, capital regulation, lending limits, and laws against securities and other abuse. Evidence on whether this implicit deposit protection has extended into commerce is mixed. The fact that the traded equity and venture capital markets in Germany are very thin, for example, could suggest that banks enjoy artificially low costs of funds and out-compete other finance mechanisms.

In contrast, the prominence of German bank lending in corporate finance also would be expected if there were informational and control advantages to equity interlocks. That is, it need not signal an exploitation of governmental safety nets. This interpretation is reinforced by the fact that the ownership of banks by nonbanks, although permitted, is not widespread. Using asset measures, only about 5 percent of German banks have nonbank parents. This implies that any funding advantages present in those links are minor.

Continuing debate

Universal banking has existed in a country that has enjoyed rapid postwar economic development and a relatively stable banking environment. To the extent that the Germans themselves have misgivings about their banking system, they do not appear to be our typical concerns about the stability of the banking sector or the desire for the banking system to be more supportive of business and industry. Rather, the misgivings seem to focus on universal banking's potential for concentrating economic power. This provides an interesting contrast to the content of debate about banking reform in the United States.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 11/25/87	Change from 11/18/87	Change from 11/26/86 Dollar	Percent[7]
Loans, Leases and Investments[1] [2]	207,488	− 1,045	1,904	0.9
Loans and Leases[1] [6]	183,465	− 773	− 1,472	− 0.7
Commercial and Industrial	51,214	− 147	428	0.8
Real estate	72,427	136	5,598	8.3
Loans to Individuals	36,893	− 21	− 4,675	− 11.2
Leases	5,430	15	− 153	− 2.7
U.S. Treasury and Agency Securities[2]	16,639	− 325	3,709	28.6
Other Securities[2]	7,383	52	− 335	− 4.3
Total Deposits	206,879	379	− 3,061	− 1.4
Demand Deposits	52,180	738	− 4,463	− 7.8
Demand Deposits Adjusted[3]	35,450	− 11,832	− 16,267	− 31.4
Other Transaction Balances[4]	19,864	− 157	1,552	8.4
Total Non-Transaction Balances[6]	134,835	− 201	− 151	− 0.1
Money Market Deposit Accounts—Total	44,079	− 239	− 2,340	− 5.0
Time Deposits in Amounts of $100,000 or more	31,849	211	− 1,213	− 3.6
Other Liabilities for Borrowed Money[5]	22,660	− 1,151	− 5,152	− 18.5

Two Week Averages of Daily Figures	Period ended 11/16/87	Period ended 11/2/87
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (−)	18	86
Borrowings	6	4
Net free reserves (+)/Net borrowed(−)	12	81

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change